

Presenter:

TOM PRICE, CPA

State of Tennessee
June Judicial Conference
Valuation Fundamentals and Applications
Chattanooga, Tennessee
June 15, 2011

Prepared by
Thomas M. Price CPA/ABV/CFF, CVA
Price CPAs, PLLC
3825 Bedford Avenue, Suite 202
Nashville, Tennessee 37215

Valuation Standards:

Uniform Standards of Professional Appraisal Practice (USPAP) – General set of professional standards that will apply to most any appraisal whether the appraisal is of real estate, business, interest in a business or intangible asset. Most of the following accreditation organizations endorse the USPAP standards but also have their own standards members are to adhere to.

1. American Society of Appraisers – ASA designation
2. Institute of Business Appraisers – CBA designation
3. National Association of Certified Valuation Analysts – CVA designation
4. American Institute of Certified Public Accountants – ABV designation

The requirements for each designation will vary. A summary of requirements is included in your materials.

Standards of Value:

You may be most familiar with these terms, but the type of buyer, specific purpose of the valuation, and circumstance under which the valuation is performed, will affect the choice of a standard of value and even the parameters applied to that standard.

1. Fair Market Value – defined by Revenue Ruling 59-60; The amount at which property will change hands between a willing buyer and willing a willing seller, neither being under compulsion and both having reasonable knowledge of the relevant facts.
 - A. Fair market value assumes a cash transaction. In other words provisions of earn outs, seller financing, stock in lieu of cash and other incentives to buyer and seller found in some transactions in the open market are not considered in the definition of fair market value. Provisions such as I have mentioned, represent the negotiation between buyer and seller to arrive at two values for the business, one of which will be proved in the future. In the open market place many sales of closely held businesses and professional service entities will involve seller financing. So it is important to remember that Fair Market Value assumes the seller receives cash as a result of the sale.
 - B. The buyer and seller are hypothetical people transacting on an arm's length basis, not two identifiable persons transacting on a prescribed basis or even one (the seller) selling on a prescribed basis.

- C. The date of the valuation is critical because the value is “as of” that date. The economic conditions in the markets and the industry of the subject of the valuation are considered as of the date of valuation.
-
- 2. Fair Value – as defined by the Revised Model Business Corporation Act – “the value of the shares immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable.”¹
 - A. Simply stated might be the same as fair market value without the application of discounts to the value. It is used in the case of minority shareholders with no control over the direction of an enterprise, which under FMV would probably require a discount to those minorities (non-controlling shares).
 - B. Fair value is also used in FAS 141 valuations. These valuations concern the value of identifiable intangible assets and goodwill held by a business. There is a great deal to be learned about intangible assets within these engagements much of which is helpful in distinguishing between personal and practice or personal and enterprise goodwill as it affects valuations for marital dissolution purposes.
 - C. States will define Fair Value differently depending on the situation surrounding the valuation.
-
- 3. Investment Value – The value of an investment to a particular investor based on his or her investment requirements. In contrast to fair market value, investment value is value to an individual, not necessarily value in the market place.
 - A. Sometimes called strategic value because it often incorporates elements of synergistic value inherent in combinations of related companies.¹
-
- 4. Intrinsic Value – An analytical judgment of value based on the perceived characteristics inherent in the investment, not tempered by characteristics peculiar to any one investor. Rather, this value is tempered by how these perceived characteristics are interpreted by one analyst versus another.¹
 - A. Think of intrinsic value as a buy in the stock market as recommended by one analyst versus another. The reason to invest in gold may be the devaluation of the dollar, outstanding debt of a nation, impending inflation pressure, weakness of the euro, etc. Alternatively the weakness of the dollar as compared to other currencies may increase exports of U.S. goods causing the manufacturer of those goods to increase in profitability, hence attracting investors away from gold and to those stocks favorably affected.

Day in, day out, you will most likely be considering Fair Market Value as the standard of measure and possibly Fair Value, but it is important to be aware of these other standards since some valuations, which purport to be FMV, may in fact be something else.

Premise of Value

1. Going Concern – the subject of the valuation is continuing to operate.
2. Liquidation – The subject of the valuation has ceased to do business or is in the process of winding up.

The premise of value should be stated within the valuation report. If the subject of the valuation is not being valued as a going concern, a determination of value will most likely center around the assets, liabilities, time required to wind up the business and the net assets available for distribution to the owners. Value is first determined at the entity level. Then the value of the individual's business interest is valued based on a number of factors.

Approaches to a calculation of Fair Market Value – Real Estate

1. Replacement Cost – “Asset” Based – Replacement cost.
2. Market Based – Comparison of transactions in the marketplace.
3. Income Based – Valuation of expected cash flows from the subject property

Approaches to a calculation of Fair Market Value – Business

1. Asset Based – Assets, as adjusted to value less liabilities.
2. Market Based – Comparison of transactions using several methods to determine a value.
3. Income Based- Several methods are used under this approach using single or multiple years based on historic and/or prospective results.

While these approaches appear to be almost on point with one another they vary in application. The nature of real estate based income is typically not as volatile and does not require as many moving parts as a business requires to produce income. The capitalization rates applied to net cash flow from rental activities do not vary as greatly as businesses. Real estate will typically have a residual value of land and improvements as opposed to a business with only personal (not real) property having little value independent of its intended use. Market comparisons of real estate sales will typically be more comparable and available as opposed to sales of closely held businesses whose terms and circumstance may materially vary between one another.

So beware that an approach in the valuing of real estate will equate to the same term when valuing a business.

The business valuation process, where does it start?

We have reviewed the types of values, assumptions as to the entity and the three approaches to valuing a business. There is virtually no end to the types of businesses in the marketplace. From professional practices that require some type of licensure from the state to highly regulated businesses such as banks to businesses with no regulation, or identifiable industry, a couple of common themes will usually be found, a balance sheet and income statement. At the end of the day, a business must keep score of what it accumulates and how it accumulates. This is expressed on the balance sheet and income statement. After gaining an understanding of the nature of the business, ownership, competitors, marketplace, economic conditions, etc., the valuator will begin with a historical review of the balance sheets (3 to 5 years):

The balance sheet reflects the assets, liabilities and equity of the business on a day certain, say December 31.

These assets will be classified as current, fixed, intangible and other (long term).

Current assets consist of cash, accounts receivable, inventory, prepaid expenses and any other tangible asset that will be realized as cash within one year from the balance sheet date, hence the term "current".

Fixed assets will consist of real and personal property, whose useful life extends beyond one year, typically, real estate, equipment, vehicles, furniture, fixtures, computers, etc. These assets are depreciated over their useful lives.

Intangible assets are most often referred to as goodwill whose components may be identified or not.

Other assets are typically assets other than the above that will not be realized as cash within twelve months.

Current liabilities will consist of trade accounts payable, current maturities of debt, accrued salaries and other liabilities that will be paid within twelve months of the balance sheet date.

Long term liabilities are typically the balance of debts not due within a twelve month period such as mortgages, loans from owners and term loans.

Equity is represented by capital invested by the owners and earnings retained (not paid out) by the business through the date of the balance sheet. Common stock and capital contributions represent the investment by the owners. Retained earnings represent the amount the business has earned and retained over the years of operation as of the date of the balance sheet.

Balance sheets are prepared on different bases; accrual, cash and tax. Typically the valuator will adjust the balance sheet of the business to the accrual basis of accounting. This basis is sometimes referred to as a financial basis of reporting. The accrual basis recognizes income when earned (as opposed to collected) and expenses when incurred (as opposed to when paid). The accumulated depreciation of fixed assets that has typically been reported on the tax basis is adjusted to represent the useful life of the assets as opposed to the value, if any, for tax purposes. The adjustment to an accrual basis of accounting is particularly important if the asset based approach is used to value the business. Furthermore the assets and liabilities will be individually adjusted from a cost basis (used in almost all accounting applications) to a fair market value basis when the asset approach is used.

Assets are also reviewed as to their classification as operating (essential to the business) or non-operating (owned but not essential). Non-operating assets are almost always valued separately from the operating value of the business whether an asset, market or income based approach is elected.

The historical income statements over the last three to five years are analyzed next. Sales, cost of sales, operating expenses and fluctuations from year to year are examined for consistency in reporting and classification, onetime expenses, compensation to owners and other factors are studied as the valuator assesses the profitability of the business. Income statements are also prepared on different bases of accounting. These statements may require adjustment to the accrual basis if an income approach to valuation is used.

Asset Based Approach

Fundamental Elements to Observe:

1. Accrual based balance sheet.
2. Accounts receivable adjusted to net collectible.
3. Inventory adjusted to accurate count and value.

4. Prepaid expenses (insurance, service contracts, taxes, etc.) adjusted.
5. Other assets on the balance sheet adjusted to their fair market values.
6. Real property (land and buildings) adjusted to fair market value.
7. Furniture, fixtures and equipment adjusted to market value or a reasonable estimate based on remaining life and productivity.
8. Vehicles, heavy equipment, specialized equipment, other rolling stock adjusted to market values.
9. Adjustment of current liabilities to only those amounts on hand and to be paid within twelve months of balance sheet date.
10. Accrual of income, business and franchise taxes net of prepayments.
11. Proper classification of amount due to or from shareholder/owners.
12. Proper adjustment of deferred taxes as an asset or liability. Tax losses may generate a refund or deferred tax asset. A difference in recognition of income for tax from financial purposes may result in a tax liability for financial purposes.

Once all assets and liabilities have been considered, the amount of net assets (total assets minus total liabilities), more commonly known as owners' equity (LLC, Partnership, Proprietorship) or stockholders' equity (corporation), will result in the net adjusted asset value of the entity. The next step would then be to determine the type of ownership; controlling or non-controlling, preferred or common, voting or non-voting as the fair market value of the individual's business interest is determined.

Market Based Approach

There are several methods to employ in using this approach. While this approach is being "talked up" more and more in various seminars due to the availability of data, it still has the major drawback of the subject business' comparability to the transactions in the market place. If the business being valued is large enough within its particular industry to consider its competitors who may even be publicly traded to be peers. Other businesses within certain industries may sell according to a rule of thumb used in a particular industry. Rules of thumb should normally serve only as a sanity check to the valuator but brokers in the business of selling businesses in the market place use them on a regular basis once the historical balance sheets and income statements have been adjusted. In addition to the two methods listed below, valuation analysts will also use a multiple of earnings method and gross revenue multiples method to derive a market based approach. However both of these methods may be a part or product of the methods described below.

Two primary methods of valuation used with the Market Based Approach:

1. Guideline Publicly Traded Company Method – The publicly traded comparable company's per share price is used to develop and apply to the subject company's outstanding shares. This requires analysis of "equity value measures" of the subject company that are then compared to those of the publicly traded companies in the industry. For example, the amount of revenue, net income from operations, cash flow from operations, working capital, net income before taxes, compensation of officers and dividend paying capacity are all considered in developing a measure of value. If say the subject company earns net income of \$100,000 or \$1,000 per share and the comparable publicly traded companies of the same size and industry earn \$1,000 per share AND those shares trade at an average of three times earnings per share, the subject company will be worth \$3,000 per share times the number of outstanding shares or \$3,000,000. A per share value determined under this method represents a marketable, non-controlling interest. Therefore the application of a market or minority discount may be inappropriate or the application of a control premium may be appropriate.
2. Comparative Transaction Method – An analysis is made of sales of businesses that are available in various databases. These databases may be researched by industry, then by size (gross revenue or total assets) and other factors in an effort to find comparability between the search results and the subject business. The financial data used in this method is very similar to the data used in the Guideline Publicly Traded Company Method. In fact, both the Market and Income methods utilize many of the same balance sheet and income statement amounts, ratios and values, as the valuator works towards a conclusion. If comparability can be determined, key multiples are examined of the sales price to: gross revenue, net income before and after taxes, book value, earnings before interest, depreciation and taxes (EBITDA) and other operating results. These multiples are then applied to the subject business' operating results to derive a value.
 - A. There are drawbacks to using the market method even though one would assume an arm's length transaction resulting in a fair market value. In fact it may be a fair market value between the parties, but was the buyer an investor not working in the business, an investor buying the business for a job, a buyer already in the same industry looking to expand or in other words a particular buyer rather than the hypothetical buyer we spoke of in our definition of fair market value.
 - B. Comparability of the sales transaction to a cash transaction is sometimes hard to determine. Is there an earn out based on future success, was the sales price affected

by the owner continuing to be employed, was real property involved either in the sale or a lease between the buyer and former owner?

Even though the market method can be difficult to apply to a single business, it is very helpful in comparing the findings to the income and asset methods. It may in fact validate one or both of the other methods by yielding a similar result. When industries are in periods of consolidation or comparability is high, it may be superior to the other two methods in reaching a conclusion of value.

Fundamental Elements to Observe:

1. Economic conditions present at the time of the comparable sales.
2. Steps described to establish financial comparability between the subject business and marketplace transactions.
3. Steps described to establish regional, industry and management comparability between the subject business and marketplace transactions.
4. Years between marketplace data and the current year of valuation.
5. Adjustments made to the financial information of the subject business to establish comparability to the marketplace data.
6. Value conclusion based on consistent application of comparable multiples between the subject business and marketplace transactions.

Income Based Approach

Both income based approaches rely on discounts and/or capitalization rates in order to derive a value based on the net income of the business.

Essentials of the Discounted Economic Income Method (Discounted cash flow method)

The essence of the discounted economic income method is twofold:

1. Projecting prospective economic income. The first step is to project the amount and timing of all economic income that the business is expected to produce for its owner(s) in the future.
2. Discounting prospective economic income to present value. The second step is to discount each flow of economic income back to a present value at a rate that reflects the risk (degree of certainty or uncertainty) of receiving that economic benefit in the amount and at the time anticipated in the projection.¹

As inferred above, the term net cash flow is most often used to describe economic income. You will typically find calculations of value based on net cash flow to equity or net cash flow to invested capital.

Equity is the ownership interest. This interest is described as owner's equity in a proprietorship, member's equity in a PLLC or LLC, partner's equity in a partnership or stockholder's equity in a corporation. Equity would then be the sum of the owner's capital/stock plus earnings remaining in the business as of the balance sheet date (retained earnings).

Invested capital typically includes the equity plus short term and long term interest bearing debt.

These differences are important. Simply put, the value of the equity interest will require a discount and capitalization rate. The value of the invested capital will include a discount rate and cost of debt (typically the interest rate) applied on a weighted basis to calculate the total value.

The use of a discounted approach requires a number of future periods, typically four to five plus a terminal year. The discount rate is applied to the cash flow of the future period and a present value is calculated. The sum of the present values for each period including the terminal year equates to the total (100%) value of the equity interest (business value).

Essentials of the Capitalized Economic Income Method

Like the discounted economic income method, the essence of the capitalized income method is twofold:

1. Projecting an anticipated economic income stream. As opposed to projecting the amount and timing of each individual economic income flow the business is expected to produce for its owner, the direct capitalization method requires projecting a single, normalized amount of economic income.
2. Capitalizing the expected economic income amount to produce a present value. This second step involves dividing the expected economic income (cash flow) by a rate that reflects the risk (degree of certainty or uncertainty) of receiving that expected amount, including expected growth, on a regular basis.¹

The use of the capitalized approach requires a single period only, perhaps derived from multiple historic years as affected by the business' outlook in the future. You may find the valuator averages the prior years to arrive at an amount to capitalize if those years varied greatly and no trend could be determined. On the other hand, the years may be weighted and averaged to arrive at an amount if a trend might be developed.

Fundamental Elements to Observe under both income methods:

1. Review the fundamental elements observed in the asset and market based approaches.
2. Note normalization entries for onetime expenses, compensation to owners, benefits to owners, non-business related expenses, cash to accrual adjustments.
3. Note when calculating net cash flow, sometimes called free cash flow that working capital requirements, fixed asset purchases and income taxes are considered.
4. Income taxes are typically calculated on net income and the net result of normalizing entries as if the business is taxed as a C type corporation. That is a corporation that pays tax at the corporate level on its income. This holds true whether the business being valued is a proprietorship, LLC, PLLC, S Corp. or partnership (general or limited).
5. Has there been an assessment of the business's ability to operate in the future?
6. Are the rates of growth applied under the discount method supportable by the report, the industry analysis and general economic conditions?
7. Are non-operating assets, excess working capital (if any), deferred tax assets or liabilities and real estate separately stated values?
8. Has the basis for the discount and/or capitalization rate been stated and used appropriately?

Discount and Capitalization Rates

As we have already discussed, discount and capitalization rates represent the certainty or uncertainty (risk) for the streams (discount) or stream (capitalization) of cash flow (income). These rates may be applied to net income, operating income, cash flow, dividends paid or any variation on these sources of measurement. The difference in a discount or capitalization rate is essentially the growth expected in the future period. So if a discount rate has assumed a three percent growth rate, the capitalization rate will be three percent less than the discount rate.

How are these rates determined? There are a number of approaches. I like to eliminate as much subjectivity as possible, so I will typically use a build up model based on level of risk in the market place over a period of time per general area of investment. The Ibbotson Valuation or SBBI and Cost of Capital books issued each year are the usual sources for this information.

The buildup begins with a riskless rate plus a premium that an equity investor would demand, plus an additional rate to account for the size of the business as compared to the industry, plus or minus specific industry risk and finally plus specific company risk.

The rates are developed from the public bond and equity markets. Please note these are after tax rates. The sum of the risks equals the discount rate. The sum of the risks minus the growth rate equals the capitalization rate. Each build up is then applied to a periodic stream of cash flow (discount) or a single period of cash flow (capitalization) to calculate the value of 100% of the business.

The build up and application of either rate is an easily misunderstood and miss-applied portion of the valuator's effort to calculate value. The valuation report must be carefully reviewed to determine whether or not the assumptions in building up the risk rate were reasonable, supportable and properly applied.

Discounts – Lack of Marketability, Lack of Control

Marketability

In valuation terms what is marketability? What is a valuator referring to when he applies a marketability discount? Is it applied at the 100% equity level, 51% or over ownership level, 50% or less ownership level, all three levels, two of the three or just one?

Is the marketability discount applicable at a rate experienced by companies before an IPO or on a restricted public company stock basis? What if the business being valued will never go public, does not have restricted stock, and will not be sold after the valuation?

Does valuation theory clash with reality in a valuation for marital dissolution purposes when the entity will not be sold? And by the way, how many of us ever valued a company to determine its selling price and then told the owners we would discount that selling price for marketability purposes before we offered it for sale? Answer none.

Okay, marketability has to do with liquidity. Liquidity has to do with being converted to cash on a readily available basis. Readily available compared to what, well perhaps the two to three

days required to realize the sales proceeds of a publicly traded security and the ease of converting the security to cash with a readily available market.

Marketability, according to Jack P. Friedman, Barron's Dictionary of Business Terms, 2nd edition, (Hauppauge, NY: Barron's 1994), p.363 is the "Speed and ease with which a particular product or investment may be bought and sold. In common use, *marketability* is interchangeable with *liquidity*, but *liquidity* implies the preservation of value when the security is bought or sold."

We typically think of marketability discounts being applied to minority interests in closely held businesses. While selling a minority interest in such a business may be more difficult, a marketability discount would theoretically apply to a controlling interest as well. Since marketability and liquidity are so closely linked, the time and risk associated with the sale of either a controlling or minority interest will differ from the sale of a publicly traded security.

So marketability, or the lack thereof, may affect the allocation of assets in a marital dissolution if one party receives liquid/marketable assets and the other receives an interest not readily converted to cash. By the same token, accepting a lack of marketability discount against the value of the owner's interest and then granting that owner a larger portion of the marital estate because of liquidity, might result in a "double dip" into the marital estate.

Factors affecting marketability (liquidity):

1. Cost of the sale – professional, brokerage, administrative.
2. Risk in the amount the interest will actually be sold.
3. Terms of the sale – cash, cash and a note, cash and a note and earn out?
4. Time required converting from an ownership interest to cash.

Lack of Control

A non-controlling interest in a closely held business has inherent issues. While any of us who own publicly traded stocks may realize we own a non-controlling interest in a business enterprise, the concern is not great since there is liquidity associated with that interest.

The issue of applying a discount to a non-controlling interest may be different from state to state, according to the reason for the valuation. This is where fair value rather than fair market value may apply if a discount for lack of control is not permitted. But anyone who has owned a non-controlling interest in a closely held business will attest to its value being less than one of control. A non-controlling owner may not ultimately set the course of the business, declare

dividends, determine compensation, hire, fire or train employees or determine financial operating parameters to guide the business. So a discount for lack of control may be warranted.

Both the marketability and lack of control discounts may apply to the value of a business interest. The lack of marketability deals with liquidity. The lack of control has to do with just that. A lack of control increases the difficulty of converting that ownership to cash. Accordingly, the discounts are applied in an order. Theoretically, the controlling interest is assessed a control premium, then discounted for a lack of marketability, but not to the extent of the discount applied to a non-controlling interest. A non-controlling interest will be discounted for a lack of control and discounted further for lack of marketability. The discounts should not be added together and applied in one calculation.

Goodwill – Personal, Enterprise or Both

Goodwill is an intangible asset. It represents the excess paid for a business, over and above the net adjusted assets, personal and real. You will hear it referred to as “blue sky” in relation to car dealerships. Goodwill may or may not be identifiable. The subject of goodwill, its identifiable parts, and finally the unidentifiable, would require another course devoted entirely to the subject. It can be a substantial portion of value when applied to a business and even professional service businesses. In Tennessee, personal goodwill is not considered an asset for property division in a marital dissolution. However business or enterprise goodwill is allowed as a value for marital dissolution purposes. The distinction between the personal and enterprise goodwill is not easy to make.

An analysis is included in the PowerPoint portion of this presentation.

¹PRIMARY SOURCE: Valuing Small Businesses and Professional Practices, Third Edition, Shannon P. Pratt, DBA,CFA,FASA, CBA, Robert F. Reilly, CFA, ASA, CPA, and Robert P. Schweihs, ASA.

State of Tennessee
June Judicial Conference
Valuation Fundamentals and Applications
Chattanooga, Tennessee
June 15, 2011

Prepared by
Thomas M. Price CPA/ABV/CFF CVA
Price CPAs, PLLC
3825 Bedford Avenue, Suite 202
Nashville, Tennessee 37215

Normalizing Entries Adjusted Income Statement

Capitalization of a Single Period

Contractor, Inc.
Historical and Adjusted Financial Statements

	Historical Book Basis 12/31/2008	2008 Adjustments	Adjusted 12/31/2008	Historical Book Basis 12/31/2007	Historical Book Basis 12/31/2006	Historical Book Basis 12/31/2005	Historical Book Basis 12/31/2004
Construction Revenues	\$ 28,841,157	\$ -	\$ 28,841,157	\$ 44,990,150	\$ 28,003,628	\$ 23,029,207	\$ 27,246,349
Contract Costs							
Materials	1,487,210	-	1,487,210	2,818,219	1,253,653	1,114,255	1,408,169
Labor	2,391,028	-	2,391,028	2,589,032	1,505,717	1,383,067	1,392,435
Subcontracts	19,794,807	-	19,794,807	32,049,442	20,815,598	17,227,110	19,684,963
Other	2,654,951	-	2,654,951	4,823,437	2,549,408	1,857,190	3,044,886
Total Contract Costs	26,327,996	-	26,327,996	42,280,130	26,124,376	21,581,622	25,530,453
Gross Profit	2,513,161	-	2,513,161	2,710,020	1,879,252	1,447,585	1,715,896
	8.71%		8.71%	6.02%	6.71%	6.29%	6.30%
General and Administrative Expenses							
Officers' salaries	191,602	-	191,602	191,932	186,322	179,677	133,033
Administrative salaries and other salaries	654,360	-	654,360	729,939	582,645	554,375	482,884
Bonuses	431,818	(103,847)	327,971	1,170,478	212,320	202,787	614,162
Health insurance and related benefits	229,206	-	229,206	175,861	135,187	133,037	123,321
General insurance	114,622	-	114,622	94,349	113,283	91,114	79,855
Advertising and promotion	32,769	-	32,769	22,270	23,119	56,785	47,029
Travel and entertainment	105,054	-	105,054	99,506	88,388	51,705	56,076
Dues and subscriptions	30,183	-	30,183	41,817	32,710	38,318	39,567
Depreciation	194,793	-	194,793	166,056	124,055	103,176	73,928
Office supplies and related expenses	32,813	-	32,813	23,657	21,090	16,390	16,544
Auto and truck expense	71,798	-	71,798	62,385	43,681	32,324	50,289
Equipment and vehicle repairs and maintenance	36,906	-	36,906	28,411	29,598	32,615	22,672
Postage	8,029	-	8,029	10,181	6,638	6,722	9,254
Telephone	39,494	-	39,494	43,351	39,638	33,525	30,743
Legal and professional	61,526	-	61,526	66,280	79,166	65,631	57,136
Taxes and licenses	32,778	-	32,778	26,683	28,676	29,087	23,314
Unsuccessful bids	158,020	-	158,020	89,269	57,020	53,992	34,766
Employee education and seminars	8,913	-	8,913	7,573	14,643	14,447	3,420
Computer consulting and software support	43,158	-	43,158	52,473	22,611	27,344	18,885
401(k) plan matching contribution	48,388	-	48,388	49,300	40,381	39,315	37,737
Office rent	158,382	-	158,382	79,975	79,975	79,975	79,975
Headquarters repairs and maintenance	80,490	-	80,490	44,897	28,304	31,510	33,543

Contractor, Inc.
Historical and Adjusted Financial Statements

	Historical Book Basis 12/31/2008	2008 Adjustments	Adjusted 12/31/2008	Historical Book Basis 12/31/2007	Historical Book Basis 12/31/2006	Historical Book Basis 12/31/2005	Historical Book Basis 12/31/2004
General and Administrative Expenses (continued)							
Utilities	34,016	-	34,016	26,417	24,893	22,623	23,714
Miscellaneous	9,428	-	9,428	8,065	6,425	5,617	5,635
Less: reimbursed expenses from related third parties	(86,097)	(160,000)	(246,097)	(246,472)	(270,808)	(237,732)	(181,569)
Less: overhead allocated to contract costs	(274,701)	-	(274,701)	(368,349)	(197,614)	(219,022)	(228,241)
Total General and Administrative Expenses	<u>2,447,748</u>	<u>(263,847)</u>	<u>2,183,901</u>	<u>2,696,304</u>	<u>1,552,346</u>	<u>1,445,337</u>	<u>1,687,672</u>
Income from Operations	65,413	263,847	329,260	13,716	326,906	2,248	28,224
Other Income							
Interest income	19,826	-	19,826	73,677	30,958	23,140	12,563
Discounts	3,377	-	3,377	5,802	2,426	4,578	3,299
Gain on sale of equipment	4,920	-	4,920	9,175	4,396	12,937	-
Miscellaneous income	148	-	148	175	838	1,255	519
Total Other Income	<u>28,271</u>	<u>-</u>	<u>28,271</u>	<u>88,829</u>	<u>38,618</u>	<u>41,910</u>	<u>16,381</u>
Other Expenses							
Interest Expense	55,705	-	55,705	60,109	4,393	5,506	-
Contributions	27,979	-	27,979	32,435	21,430	28,653	30,320
Total Other Expenses	<u>83,684</u>	<u>-</u>	<u>83,684</u>	<u>92,544</u>	<u>25,823</u>	<u>34,159</u>	<u>30,320</u>
Net Income	<u>\$ 10,000</u>	<u>\$ 263,847</u>	<u>\$ 273,847</u>	<u>\$ 10,001</u>	<u>\$ 339,701</u>	<u>\$ 9,999</u>	<u>\$ 14,285</u>

The financial information presented above is included solely to assist in the development of value conclusions and it should not be used to obtain credit or for any other purpose. Because of the limited purpose of this presentation, the financial information may be incomplete and contain departures from generally accepted accounting principles. We have not audited, reviewed or compiled this presentation and express no assurance on it.

Contractor, Inc.
Free Cash Flow Calculation

Debt Free After Tax Cash Flow					153		Cost of Equity		Factors	Weight	Weighted Costs
SIC					2008	2007	2006	2005	2004		
Unadjusted Pretax Income					10,000	10,001	339,701	9,999	14,285		
Officer Compensation Adjustments:											
CEO					52,923	443,431	-	-	224,584		
Reimbursement of Overhead - 5 Star					160,000						
Healthcare Expenses - Officer					40,716						
Personal Autos - gas, etc.					9,608						
Adjusted Pretax Income					273,247	453,432	339,701	9,999	238,869	4.26%	72.05%
											100.00%
											3.07%
											9.58%
Add: Interest Expense					55,705	60,109	4,393	5,506	-	1,000,803	35%
										1,825,447	65%
										2,826,250	100%
Total Weight					328,952	513,541	344,094	15,505	238,869		
					1	1	1	1	1		
Average All Equity Adjusted Pretax Income					288,192					Amt.	Annual Int
Less: Estimated State Income Taxes @ 6.5%					18,732					130,000	6,370
Before Federal Taxes					269,460					145,728	11,075
										9,777	743
Less: Federal Taxes					79,866					25,335	1,837
All Equity Adjusted Net Income					189,593					310,840	20,025
Add: Average Depreciation/Amortization					132,402					689,963	43,813
Adjust for Working Capital Requirements					-					1,000,803	63,838
Adjust for Capital Expenditure Requirements					(188,846)						
Calculated All Equity After Tax Free Cash Flow					133,149		Cap-X				
Capitalization Rate					9.58%	Yr	Net				
						2008	Additions				
Capitalized Value					1,389,785	2007	237,580				
						2006	203,141				
Less Debt					(1,000,803)	2006	116,831				
						2005	182,550				
						2004	204,130				
Value of Equity					388,982		188,846				

CALCULATION OF VALUE

████████ Contractor, Inc.

Stockholders' Equity per 12-31-08 Balance Sheet	\$1,825,447		
Adjustments:			
Record non-operating asset autos at Kelly Blue Book	-35,461		
Remove depreciation on non-operating assets	19,055		
Remove Club Membership	<u>-51,500</u>		
	-67,906		
		\$1,757,541	
Marketability Discount – 30%		<u>-\$527,262</u>	
Net Adjusted Book Value			<u>\$1,230,279</u>

████████ LLC

Owner's Equity per 12-31-08 Balance Sheet	\$117,970		
Adjustments:			
None			
		\$117,970	
Marketability Discount – 15%		<u>-17,695</u>	
Net Adjusted Book Value			<u>\$100,275</u>

████████ Inc.

Stockholder Equity per 12-31-08 Balance Sheet	\$174,691		
Adjustments:			
None			
		\$174,691	
Marketability Discount – 15%		<u>-\$26,203</u>	
Net Adjusted Book Value			<u>\$148,488</u>

████████ Inc.

Stockholder Equity per 12-31-08 Balance Sheet	\$1,157,932		
Adjustments:			
2005 Mercedes SL500 to Kelly Blue Book	<u>-11,565</u>		
Net Adjusted Asset Value – 100% Interest		\$1,146,367	
Marketability Discount – 15%		<u>-\$171,955</u>	
Net Adjusted Book Value			<u>\$974,412</u>

Normalizing Entries Adjusted Income Statement

Discount of Future Periods

Inc.
Historical Financial Comparison
Statements of Operations

	2009	2008	2007	2006	2005
Revenues	\$ 42,219,255	\$ 47,976,255	\$ 52,392,607	\$ 57,021,559	\$ 49,624,210
	100.00%	100.00%	100.00%	100.00%	100.00%
Cost of Revenues	29,934,085	34,618,657	36,058,997	37,428,754	31,692,960
	70.90%	72.16%	68.82%	65.64%	63.87%
Gross Profit	12,285,170	13,357,598	16,333,610	19,592,805	17,931,250
	29.10%	27.84%	31.18%	34.36%	36.13%
Expenses					
Officers Salaries	6,063,160	4,878,237	8,338,291	13,884,004	12,465,736
Salaries and Wages	3,632,293	3,638,351	3,730,337	3,221,181	3,660,091
Repairs and Maintenance	87,767	159,011	171,616	158,090	160,737
Rent	135,310	357,314	352,805	355,024	341,037
Depreciation	278,047	334,913	366,310	383,105	559,684
Advertising	11,669	49,050	31,092	38,874	17,370
Pension Expense	482,812	538,305	522,402	602,104	490,061
Employee Benefits/Insurance	391,696	472,854	491,297	453,528	413,888
Freight and Express	194,286	223,670	160,644	113,732	127,872
Computer Expense	127,841	139,075	118,880	118,792	120,702
Supplies	113,722	128,873	128,623	110,169	101,290
Dues and Subscriptions	18,500	28,914	25,351	25,428	25,476
Office Supplies	62,766	81,809	93,495	101,820	91,599
Officers Life Insurance	-	3,518	3,518	-	23,175
Utilities	82,006	76,215	76,165	68,913	54,032
Vehicle Expense	102,949	577,983	505,728	482,602	395,002
Legal and Accounting	185,842	134,501	116,942	338,799	142,381
Postage	17,529	22,319	20,825	19,607	15,981
Sales Expense	6,616	63,566	29,372	21,423	7,153
Board of Directors Expense	-	5,860	6,832	56	-
Expenses	24,851	24,851	17,273	18,761	20,781
Administrative Services	58,740	58,740	58,740	58,740	58,740
Employee Expenses	-	66,598	71,020	42,279	27,529
Travel	44,700	65,343	58,555	55,086	49,250
Training and Education	18,233	31,232	46,070	17,884	14,186
Quality Certification	-	7,317	5,938	9,348	6,156
Scholarships	31,853	23,366	18,508	7,132	2,430
Temp Labor	-	-	-	-	-
	0.00%	0.00%	0.00%	0.00%	0.00%

Inc.

**Historical Financial Comparison
Statements of Operations**

	2009	2008	2007	2006	2005
Bank Charges	22,257	6,849	8,771	0.00%	0.00%
Taxes and Licenses	359,733	474,193	553,520	1.06%	0.89%
Kitchen Subsidy	52,206	-	-	0.00%	0.01%
Miscellaneous	-	22	1	0.00%	0.00%
Meals and Entertainment	200,549	221,793	220,720	0.42%	0.36%
Total G&A Expenses	12,807,933	12,894,642	16,349,641	34.08%	44.66%
					19,982,737
					41.65%
Other Income/Expenses					
Interest Income	176,037	174,667	388,943	0.74%	0.57%
Interest Expense	-	(165,330)	(302,633)	-0.58%	0.00%
Freight Billed	167,602	168,266	179,332	0.34%	0.00%
Administration Services	156,244	155,004	155,004	0.30%	0.00%
Bad Debt Expense/Recovery	(109,480)	(68,025)	(92,571)	-0.18%	0.00%
Other Income	-	12,334	5,312	0.01%	0.00%
Cash Discount Earned	411,339	517,025	530,278	1.01%	1.46%
Dividend Income	-	3,345	1,119	0.00%	0.00%
Gain/Loss on Sale of Assets	-	(2,176)	13,000	0.02%	0.00%
Donations	(13,555)	(17,835)	(17,114)	-0.03%	-0.01%
Total Other Income	788,187	777,275	860,670	1.64%	2.05%
					942,063
					1.90%
Net Income/Loss	\$ 265,424	\$ 1,240,231	\$ 844,639	1.61%	-1.16%
					\$ (1,109,424)
					-2.24%

The financial information presented above is included solely to assist in the development of value conclusions and it should not be used to obtain credit or for any other purpose. Because of the limited purpose of this presentation, the financial information may be incomplete and contain departures from generally accepted accounting principles. We have not audited, reviewed or compiled this presentation and express no assurance on it.

Free Cash Flow and EBITDA Calculations

Inc.

	2009	2008	2007	2006	2005
Revenues	42,219,255	47,976,255	52,392,607	57,021,559	49,624,210
	100%	100%	100%	100%	100%
Cost of Revenues	29,934,085	34,618,657	36,058,997	37,428,754	31,692,960
	71%	72%	69%	66%	64%
Gross Profit	12,285,170	13,357,598	16,333,610	19,592,805	17,931,250
	29%	28%	31%	34%	36%
Operating Expenses	12,807,933	12,894,642	16,349,641	21,423,942	19,982,737
	30%	27%	31%	38%	40%
Other Income/Expense	788,187	777,275	860,670	1,169,418	942,063
	2%	2%	2%	2%	2%
Net Income	265,424	1,240,231	844,639	(661,719)	(1,109,424)
	1%	3%	2%	-1%	-2%
Normalization Adjustment					
Add:					
Officer's Compensation	4,532,506	3,687,074	7,159,964	12,109,006	10,858,059
One Time Professional Fees			196,515		
Normalized Income	4,797,930	4,927,305	8,201,118	11,447,287	9,748,635
	11%	10%	16%	20%	20%
Add:					
Depreciation & Amortization	1,831,979	1,912,957	1,558,067	1,500,355	1,449,474
Less:					
Income Tax - State	294,613	239,660	478,171	787,085	705,774
6.5%					
Income Tax Federal	1,576,161	1,206,595	2,407,408	3,962,672	3,553,300
35.0%					
Working Capital Change	(989,632)	(759,174)	(795,720)	1,271,609	1,326,035
17.2%					
Capital Expenditures	1,092,310	1,060,495	1,029,607	1,029,607	999,618
Free Cash Flow	4,656,457	5,092,686	6,639,719	5,896,669	4,613,382
	11%	10.62%	12.67%	10.34%	9.3%
Normalized EBITDA	6,648,360	6,926,481	9,817,903	12,901,641	11,120,983

The financial information presented above is included solely to assist in the development of value conclusions and it should not be used to obtain credit or for any other purpose. Because of the limited purpose of this presentation, the financial information may be incomplete and contain departures from generally accepted accounting principles. We have not audited, reviewed or compiled this presentation and express no assurance on it.

Capitalization of Earnings – Income Approach

Earnings before interest, taxes, depreciation, and amortization (EBITDA) are used to analyze a company's profitability before non-operating expenses and non-cash charges. We calculated an average EBITDA based on the five years analyzed and applied a pre-tax capitalization rate. While this method was not ultimately chosen, the calculated values were very comparable to that of our final conclusions and provided further comfort in our selected method.

As previously discussed, [REDACTED] approached potential buyers with an EBITDA based fair market value. They found this to be the approach all of the potential buyers utilized and believe it is a better indicator of fair market value. Based on the range of multiples used in the 2006 bids (5.75 to 7.1) the current fair market value of [REDACTED] would range from \$38,228,070 to \$47,203,356 plus the addition of all free cash as of the purchase date. The excess cash held by the company as of December 31, 2009 was \$3,511,111 which would result in a range of values from \$41,739,181 to \$50,714,467. Mr. [REDACTED] of [REDACTED] felt the current state of the credit markets in the United States as of December 31, 2009 might reduce the EBITDA multiple to 5.75 which yields a \$41,739,181 fair market value.

Capitalization of Cash Flows – Income Approach

Free Cash Flow

Free Cash Flow is the measure of income that is used to value [REDACTED] using the income approach. [REDACTED] had no interest bearing debt as of the valuation date, and, thus, the entity free cash flow and the equity free cash flow are the same. The calculations are provided in the following exhibit.

Beginning with the Net Income as provided by the financial statements, a normalizing adjustment was made to the compensation expense to make the normalized income conform to other firms in the same industry with respect to officer income. The ERI data on the compensation for the top three officers for firms of the same size in the same industry was used as a guideline. The compensation expense was reduced by the amount that the compensation of the top three officers of [REDACTED] exceeded the industry standard as provided by ERI. This adjustment produced the normalized income.

Legal and professional fees totaled \$338,798 for the year ended December 31, 2006. Of this amount [REDACTED] received \$177,431 with [REDACTED] receiving \$90,705. We reduced the 2006 expenses by \$196,515 to \$142,283 which is the average of the five years 2004 – 2009 excepting 2006.

The non-cash expense, depreciation and amortization, used to arrive at net income were added to normalized income. Several subtractions were made. The first was that the income of the company was tax-effected. The consensus, although not unanimous, is that pass through entities and taxable entities should have the same value, and when valuing pass through entities, they should be treated as taxable entities. The appropriate state and federal taxes were calculated.

As a company grows it requires additional working capital. Over the sample period, working capital averaged 17.2% of revenue. As revenue changes on the average its working capital requirement will change by 17.2% of the amount of the revenue change. The working capital requirement was imputed to change by this percent of the revenue changes over the sample period.

Free Cash Flow (continued)

Capital expenditures tend to be extremely variable, and we smoothed them over the six year period. First, the expenditures for the years with the largest and smallest expenditures were eliminated, and the expenditures for the middle four years were averaged. This average expenditure was assigned to the middle two years, 2006 and 2007. A 3% percent inflation rate was assumed, and the expenditures for the years before 2006 were decreased by 3% per year, and the expenditures for the years after 2007 were increased by 3% per year.

The tax effects, imputed working capital changes, and capital expenditure requirements were subtracted from normalized income to arrive at the Free Cash Flow for each year. Please see Tab A, Free Cash Flow and EBITDA calculation.

The last row of the exhibit provides the normalized EBITDA values for each of the years. These were calculated by adding depreciation and amortization and state income taxes to normalized income. EBITDA is a measure of operating cash flow often used in valuing businesses.

Discount and Capitalization Rates

One method of arriving at a value indication using the income approach is to calculate the present value of anticipated future Free Cash Flow using an appropriate discount rate. Modern Portfolio Theory (MPT) states that the appropriate discount rate is the cost of capital of the cash flows. Investor's price anticipated cash flows so that they expect to earn a return that is commensurate with the riskiness of the projected cash flows. MPT states that the Capital Asset Pricing Model (CAPM) should be used to arrive at the appropriate cost of capital or discount rate to use when valuing the anticipated cash flows. The CAPM provides a cost of capital that is appropriate for the risk of the anticipated cash flows.

The CAPM begins with the risk free rate, and risk premia are added for various identified sources of risk inherent in the cash flows to be valued. The accompanying table provides the application of the CAPM for calculating the cost of capital for valuing [REDACTED]. The estimate of the risk free rate that is customary is the 20-year US Treasury Bond rate as of the valuation date. In this case this rate was 4.6% on December 31, 2009 as reported by the Federal Reserve.

The CAPM then adds a risk premium for investing in common stocks that measures the risk that cannot be diversified away by holding the subject stock in a well diversified portfolio of investments. This premium is calculated by expressing the risk of the subject stock relative to the average premium for all stocks. The average risk premium above the risk free rate for all stocks was 6.5% as reported in *Ibbotson Stocks, Bonds, Bills, and Inflation 2009 Valuation Yearbook*. The relative risk, the beta, of the stock of a debt free small company in the same industry as [REDACTED] was .48 relative to the average risk of stock investments in public companies according to *Ibbotson Cost of Capital 2009 Yearbook*. This risk premium is 3.1%, and it captures the combined risk of [REDACTED] industry risk and some of its size risk.

The size premium that is in addition to the size risk captured by the industry beta is published in *Ibbotson SBBI Valuation Yearbook*. [REDACTED] has total assets that would put it in the smallest 5% of NYSE traded companies. This group is assigned a size risk premium of 9.53%; therefore, an additional size premium of this amount is added.

Some company specific risk factors identified are a concentration of customers that produce a significant proportion of the company's revenues, and a concentration of suppliers. A couple of offsetting factors

Discount and Capitalization Rates (continued)

are a loyal workforce and above average profitability as measured by return on assets when income is adjusted for its above average officer compensation. A net risk premium of 1% was assessed for these company risks.

The cost of equity capital for [REDACTED] was estimated to be approximately 18%.

Cost of Capital – CAPM

All Equity Firm	Risk <u>Premium</u>
20-year US Treasury Bond 12/31/09 Yield	4.60%
FederalReserve.gov	
Equity Risk Premium	6.50%
<u>Ibbotson SBBi 2009 Yearbook</u>	
Industry Small Co. Unlevered Beta	<u>0.48</u>
<u>Ibbotson Cost of Capital Yearbook</u>	
Industry Small Co. Risk Premium	3.10%
Equity Risk Premium x Unlevered Beta	
Size Premium for the smallest 5%	9.50%
<u>Ibbotson SBBi Valuation Yearbook</u>	
Company Specific*	<u>1.00%</u>
Cost of Capital	<u>18.20%</u>
Say,	<u>18.00%</u>

*Concentration of Customers & suppliers
 Higher than average return on assets after adjusting officer compensation to industry
 average
 Loyal workforce

Ibbotson Cost of Capital 2009 Yearbook, SIC code 26; Small public companies
 Cost of Equity: CAPM+size, 11.4%; 3-factor, 20.25%
 WACC: CAPM+size, 11.85%; 3-factor, 19.49%

Ibbotson SBBi 2009 Valuation Yearbook
 The smallest 5% of companies have a size premium of 9.53%.

Growth Rate
Ibbotson Cost of Capital Yearbook, SIC code 26
 Analysts' estimate of growth for small public co.'s: 7.59%; say, 8.0%

The capitalization rate is defined to be the discount rate less the anticipated long term growth rate in the cash flow stream that is to be valued. In this case the analysts that follow the firms in this industry are forecasting approximately an 8 percent growth rate. With the total economy growing at 3% to 5% an 8% growth rate cannot be sustained indefinitely. In the current case a growth rate of 3% is forecast for 2010 which corresponds to the Company's expectation. Based on the company's financial strength, operating

Discount and Capitalization Rates (continued)

capacity, historic results and state and national predictors of GDP, manufacturing GDP and industry growth, the growth rate for 2011 is projected at 4% with 5% for the next three years until it reaches a 4% long-term growth rate in 2014. At this point a capitalization rate of 14% (18% - 4%) is used to value the future Free Cash Flows. The following table shows the projected Free Cash Flows and the valuation of these forecasts.

Forecast and Valuation of Free Cash Flows

<i>Cost of Capital</i>		18.00%	
<i>Long-term Growth Rate</i>		4.00%	
<i>Capitalization Rate</i>		14.00%	
<i>Valuation Date</i>		12/31/2009	
			<i>Present</i>
<u>Year</u>	<u>Growth</u>	<u>FCF</u>	<u>Value</u>
2009		4,656,457	
2010	3.00%	4,796,151	4,415,215
2011	4.00%	4,987,997	3,891,376
2012	5.00%	5,237,397	3,462,665
2013	5.00%	5,499,266	3,081,185
2014	5.00%	5,774,230	2,741,732
2015	4.00%	6,005,199	
2014	Terminal Value @12/31/2014		<u>20,367,153</u>
<i>Total</i>			37,959,325
<u>Excess Assets</u>			
<i>Cash</i>			<u>3,511,111</u>
<i>FMV @12/31/2009</i>			<u>\$41,470,436</u>

Midyear discounting

The present values of the projected cash flows are calculated using the cost of capital as the discount rate. Because the cash flows occur almost evenly throughout the year with small seasonal increases in the second and third quarters, using the mid-year discounting convention more accurately estimates their present value than using the end-of-year convention. The terminal value is calculated by capitalizing the forecast 2015 Free Cash Flow of \$6,005,199 at a capitalization rate of 18% - 4% = 14%. This produces a projected value of \$42,894,278 at 12/31/2014. The present value of this forecast is \$20,367,153. The sum of the calculated present values is \$37,959,325 which is the estimated operating fair market value of [REDACTED] as of 12/31/2009.

The company's net working capital at the end of 2009 relative to its 2009 revenue was much larger than in previous years of the sample period. The average NWC to Revenue ratio for the preceding 5 years was 17.2%, and the NWC to Revenue ratio for 2009 was 25.5%. A 17.2% ratio for 2009 would produce a NWC that was \$3,511,111 less than the amount owned by [REDACTED] at the end of 2009. Cash was the account that was larger than in previous years, and the excess cash was determined to be a non-

Discount and Capitalization Rates (continued)

operating asset. The amount of the calculated excess NWC was added to the operating value of the entity. The estimated fair market value of the entity as of the valuation date was calculated to be approximately \$41,470,436.

5.4 Reconciliation of Valuation Methods

We believe that the capitalization of income approach (EBITDA) utilized in the effort to sell 100% of [REDACTED] and the capitalization of cash flow approach represent reasonable approaches to determining value. In fact the EBITDA approach produced a value of \$41,739,181 for 100% of the equity in [REDACTED]. However, we also believe that [REDACTED] relatively constrained growth prospects and future capital expenditure requirements are more explicitly reflected in the cash flow- income approach. Therefore, we gave more consideration to the free cash flow method of the income approach in reaching our valuation conclusion of \$41,470,436 for a 100% equity interest.

[REDACTED] Inc.

Fair Market Value Calculation of a 50% Equity Interest in [REDACTED] Inc.

Fair Market Value of a 100% Equity Interest as of 12-31-09		\$	41,470,436.00
Fair Market Value of a 50% Equity Interest as of 12-31-09		\$	20,735,218.00
Less:			
Discount for a non-controlling yet a 50% Interest	10%	\$	(2,073,521.80)
		\$	18,661,696.20
Discount for lack of marketability	15%	\$	(2,799,254.43)
Fair market Value of a 50% Equity Interest after discounts		\$	15,862,441.77

5.5 Conclusion of Value

We have performed a valuation engagement, as that term is defined in the Statement of Standards for Valuation Services No. 1 (SSVS) of the American Institute of Certified Public Accountants, of a 50% equity interest of [REDACTED] as of December 31, 2009 a minority, nonmarketable basis. This valuation was performed solely to assist in the determination of the value solely for marital dissolution purposes and the resulting estimate of value should not be used for any other purpose or by any other party for any purpose. This valuation engagement was conducted in accordance with the SSVS. The estimate of value that results from a valuation engagement is expressed as a conclusion of value.

5.5 Conclusion of Value (continued)

There were no restrictions or limitations in the scope of our work or data available for analysis.

Based on our analysis as described in this valuation report, and the facts and circumstances as of the valuation date, the estimate of value of a 50% equity interest in [REDACTED] as of December 31, 2009, on a minority, nonmarketable basis is \$15,862,442. This conclusion is subject to the Statement of Assumptions and Limiting Conditions found in Section 6.0 of this report and to the Valuation Analyst's Representation/Certification found in Section 6.0 of this report. We have no obligation to update this report or our conclusion of value for information that comes to our attention after the date of this report.

Discount for Lack of Marketability

H. USING SPECIFIC COMPANY LIQUIDITY CHARACTERISTICS

Rand Curtis of Willamette provided the following matrix in "Developing and Defending Fractional Interest Valuation Discounts and Premiums." The first matrix explains the variables.

Discount for Marketability Factors	Rating of (-1)	Rating of (0)	Rating of (+1)
Income			
Are cash distributions material?	Yes	Income Taxes Only	Control Discretion
... Certain?	Yes	Uncertain or N/A	No
... Frequent?	Yes	Uncertain or N/A	No
Appreciation			
Is the entity diversified?	Yes	Uncertain or N/A	No
Is the economic risk high?	No	Uncertain or N/A	Yes
... Interest rate risk (considering both assets and liabilities)?	No	Uncertain or N/A	Yes
... Stock market/asset price risk?	No	Uncertain or N/A	Yes
... Business risk?	No	Uncertain or N/A	Yes
... Financial risk?	No	Uncertain or N/A	Yes
Are unrealized tax liabilities large?	No	Uncertain or N/A	Yes
Are growth prospects good?	Yes	Uncertain or N/A	No
Liquidity			
Are there rights to liquidation?	Yes	Uncertain or N/A	No
... Withdrawal/return of capital?	Yes	Uncertain or N/A	No
... Assignee admission?	Yes	Uncertain or N/A	No
Have there been sales of interests?	Yes	Uncertain or N/A	No
Are there transfer restrictions?	No	Uncertain or N/A	Yes
Are there insider trading restrictions?	No	Uncertain or N/A	Yes
Is there a right of first refusal?	No	Uncertain or N/A	Yes
Is there an active secondary market?	Yes	Uncertain or N/A	No
Is the holding period long?	No	Uncertain or N/A	Yes
Is there a clear exit strategy?	Yes	Uncertain or N/A	No
Are many potential buyers present?	Yes	Uncertain or N/A	No
Is there a buy-sell agreement?	Yes	Uncertain or N/A	No
Is there put/call protection?	Yes	Uncertain or N/A	No
Is there a blockage effect?	No	Uncertain or N/A	Yes
Financial			
Is there bankruptcy risk?	No	Uncertain or N/A	Yes
Are current liquid assets material?	Yes	Uncertain or N/A	No
Are capital calls mandatory and probable?	No	Uncertain or N/A	Yes
Is there unused debt capacity?	Yes	Uncertain or N/A	No
Are there outside financing sources?	Yes	Uncertain or N/A	No
Is cash flow strong?	Yes	Uncertain or N/A	No
... stable?	Yes	Uncertain or N/A	No
Can the entity change easily?	Yes	Uncertain or N/A	No
Power			
Is information available/reliable?	Yes	Uncertain or N/A	No
Are owners harmonious?	Yes	Uncertain or N/A	No

Source: Rand M. Curtiss, Developing and Defending Fractional Interest Valuation Premiums and Discounts, (Plantation: The Institute of Business Appraisers, Inc., 2003), p. 43.

The second table outlines the application of the method to determine the DLOM for a hypothetical company.

Discount for Marketability Factors	Rating	Reason
Income		
Are cash distributions material?	-1	Not today, but potential once debt is paid down
...Certain?	0	Not today, but may be once debt is paid down
...Frequent?	0	Not today, but may be once debt is paid down
Appreciation		
Is the entity diversified?		Accounted for in Company Specific Discount
Is the economic risk high?	-1	No
...Interest rate risk (considering both assets and liabilities)?	0	Some
...Stock market/asset price risk?	-1	No
...Business risk?		Accounted for in Company Specific Discount
...Financial risk?		Accounted for in Company Specific Discount
Are unrealized tax liabilities large?	0	Only upon liquidation
Are growth prospects good?	-1	Growth within existing customers has been strong
Liquidity		
Are there rights to liquidation?	1	No
...Withdrawal/return of capital?	1	No
...Assignee admission?	0	Uncertain
Have there been sales of interests?	0	Retirement of Preferred Shares
Are there transfer restrictions?	-1	No
Are there insider trading restrictions?	-1	No
Is there a right of first refusal?	-1	No
Is there an active secondary market?	1	No
Is the holding period long?	0	Unknown
Is there a clear exit strategy?	-1	Potential sale has been attempted
Are many potential buyers present?	-1	Several have expressed interest
Is there a buy-sell agreement?	1	No
Is there put/call protection?	1	No
Is there a blockage effect?	-1	No
Financial		
Is there bankruptcy risk?	-1	No
Are current liquid assets material?	0	Reasonable cash on hand
Are capital calls mandatory and probable?	-1	No
Is there unused debt capacity?	-1	Yes
Are there outside financing sources?	-1	Yes
Is cash flow strong?	-1	Yes
...stable?	-1	Yes
Can the entity change easily?	0	Unknown
Power		
Is information available/reliable?	-1	Yes
Are owners harmonious?	0	Unknown
SUMMARY		
Sum of the Ratings	-12	
Number of Factors	33	
Net Factors	21	
Net Factors / Factors Rated	63.6%	
Baseline Discount	35.0%	Median discount from Mergerstat Review
Subject Discount	22.39%	Product of the preceding two numbers.

Source: Rand M. Curtiss, *Developing and Defending Fractional Interest Valuation Premiums and Discounts*, (Plantation: The Institute of Business Appraisers, Inc., 2003), p. 43.

Goodwill

Personal vs. Business

AMERICAN SOCIETY OF APPRAISERS
23RD ANNUAL ADVANCED BUSINESS VALUATION CONFERENCE
SAN ANTONIO, TEXAS
OCTOBER 7-9, 2004

**SEPARATING PERSONAL AND BUSINESS
GOODWILL OF OPERATING COMPANIES
IN DIVORCE VALUATIONS**

PREPARED AND PRESENTED BY
ROD P. BURKERT, CPA/ABV, CVA

BURKERT VALUATION ADVISORS, LLC
314 NORTH 12TH STREET
THE OLD SHOE FACTORY #705
PHILADELPHIA, PA 19107

TEL: (215) 448 - 0650
FAX: (215) 448 - 0652
E-MAIL: rod.burkert@burkertvaluation.com

Separating Personal and Business Goodwill of Operating Companies in Divorce Valuations

Overview: Family law courts in multiple jurisdictions are requiring business appraisers to separate personal and business goodwill in valuations for marital dissolution purposes. The reason is that, in these jurisdictions, appellate courts have held that personal goodwill is not a marital asset subject to equitable distribution. Thus a process must evolve that can segregate the personal goodwill of the in-spouse business owner and exclude it from the valuation process.

This presentation is not intended to be exclusively relied upon when performing a business valuation. Rather, it is a reference source that should be consulted along with authoritative texts, current literature, and case law.

Objectives: This presentation will focus on operating companies, although the principles apply equally to professional practices. The main objectives of today's discussion will be to:

1. Review factors that can be used to assist in determining the existence of personal or business goodwill.
2. Discuss approaches that can be used to separate inalienable personal goodwill from transferable business goodwill.

CPE: 1 Hour - Other

This material is designed to provide accurate and authoritative information in regard to the subject covered. It is presented with the understanding that the author is not engaged in rendering legal, accounting, or other professional service or advice. If legal or other expert assistance is required, the services of a competent professional person should be sought.

Although the information contained in this material has been carefully compiled from sources believed to be reliable, the accuracy of the information is not guaranteed. The author specifically disclaims any personal liability, loss or risk incurred as a consequence of the use, either directly or indirectly, of any information, or advice given in this material.

All rights reserved. No part of this material may be reproduced, stored in a retrieval system, or transmitted, in any form or by any means, electronic, mechanical, photocopying, recording, or otherwise, without prior permission of the author.

**Separating Personal and Business Goodwill of Operating Companies
in Divorce Valuations**

Copyright © 2004 Rod P. Burkert, CPA/ABV, CVA

ROD P. BURKERT, CPA/ABV, CVA



Rod Burkert is a co-founder of Burkert Valuation Advisors, LLC, a business valuation and litigation consulting services firm. With a background of over 25 years of combined experience in public accounting and private industry, Mr. Burkert performs valuations for companies operating in a wide variety of industries. He works extensively in valuations for gift/estate tax planning, purchase/sale transactions, financial statement reporting, and marital dissolution proceedings and in litigation support for partner/shareholder disputes and damage/economic loss matters.

Since 1996, Mr. Burkert has been a member of and a lead instructor for the National Association of Certified Valuation Analysts' (NACVA) Training Development Team, which develops and presents professional education courses on business valuations at training centers throughout the United States. He is qualified to teach all five days of NACVA's five day training center curriculum. Mr. Burkert is Chairman of NACVA's Standards Committee and a past chairman of its Executive Advisory Board and its Education Board. He is a recipient of various NACVA instructor awards, including *Circle of Light* (the highest distinction given to NACVA instructors) and *Instructor of the Year*, and has been named one of NACVA's *Outstanding Members*.

Mr. Burkert has lectured on valuation matters for several state CPA Societies, Chambers of Commerce, Estate Planning Councils, Bar Associations, law firms, and private banking groups. He has authored valuation articles which have been accepted for publication in several professional journals and developed a course for valuing preferred stock in closely-held companies for CPA Associates International, Inc.'s 1999 Business Valuation Conference and NACVA's 2000-2004 Career Development Institutes. Mr. Burkert also developed new management courses in business valuation for the National Tax Institute's continuing professional education programs in 2001 and 2002.

Prior to forming Burkert Valuation Advisors, Mr. Burkert was a partner in and the Management Advisory Services Department Head at Reinsel & Company LLP, a Reading, Pennsylvania certified public accounting and consulting firm, where he was in charge of the firm's business valuation practice. Mr. Burkert was also employed in the audit and tax departments of Price Waterhouse in their Philadelphia, Pennsylvania and Brussels, Belgium offices, served in the operational analysis, financial reporting, and marketing analysis groups of Carpenter Technology, a Reading-based Fortune 500 specialty steel manufacturer, and a merger and acquisition analyst for two large regional banking institutions, Meridian Bank in Reading and Goldome in Buffalo, New York.

Mr. Burkert received a Bachelor of Science degree in Accounting from Albright College and a Master of Business Administration degree with a concentration in Finance from Lehigh University. Mr. Burkert is a Certified Public Accountant and has earned the designations of Accredited in Business Valuation and Certified Valuation Analyst, recognizing special training, testing, and qualification in the field of business valuation and adherence to standards established by the AICPA and NACVA, respectively. He is currently pursuing the Accredited Senior Appraiser designation from the American Society of Appraisers.

Introduction and Presenter's Note: The written material for this presentation has been modified slightly from the following article –

Burkert, Rod P., "Separating Personal and Business Goodwill of a Business in Marital Dissolution Valuations", *American Journal of Family Law*, Summer 2003, pp. 75-81.

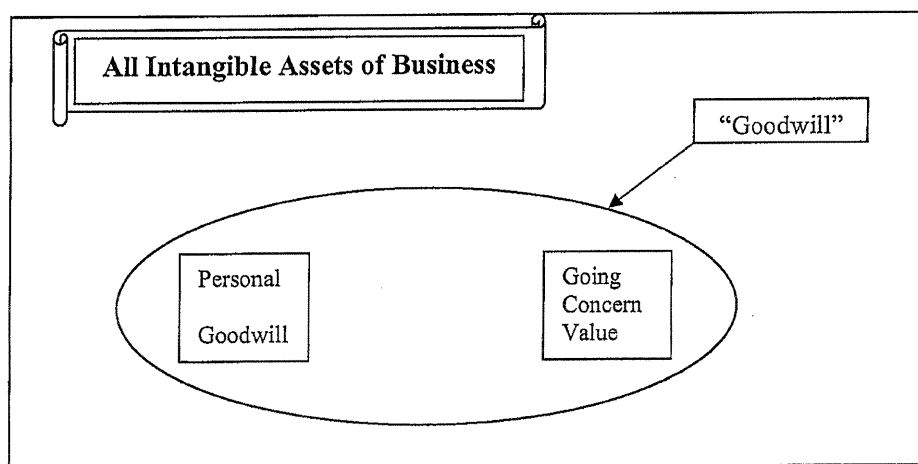
Family law courts in multiple jurisdictions are requiring business appraisers to separate personal and business goodwill in valuations for marital dissolution purposes. The reason is that, in these jurisdictions, appellate courts have held that personal goodwill is not a marital asset subject to equitable distribution. Thus, a process must evolve that can segregate the personal goodwill of the in-spouse business owner and exclude it from the valuation process.

This article builds on John Barrett's "Bifurcating Enterprise and Personal Goodwill" which appeared in a previous issue of this publication.¹ Like Mr. Barrett's article, this piece focuses on operating companies, although the principles apply equally to professional practices. Factors to assist in identifying personal goodwill from business goodwill will be covered and approaches that can be used to separate inalienable personal goodwill from transferable business goodwill for marital dissolution valuations will be debated.

What Are We Talking About

The value of a business is the sum of its tangible and intangible assets (as defined below). Most business valuation methodologies collectively value the tangible and intangible assets of the business and do not attempt to distinguish between the two. That is because most (non-divorce) valuations are meant only to value an owner's entire equity interest, and the allocation between tangible and intangible amounts is normally not a concern.

Business appraisers have identified and valued over 100 different intangible assets.² For this article, all of these intangibles can be thought of as being owned by either the in-spouse business owner or the business. To comply with evolving marital dissolution case law, marital assets must exclude the value of intangibles belonging to the in-spouse. Visually, the task can be diagrammed:



From this picture, it should be clear that “goodwill” is one of many (100+) intangible assets of a business, and personal goodwill (and going concern value) is, in turn, a component of total goodwill.

Definitions

Separating personal goodwill and business goodwill cannot begin without a basic vocabulary. *The International Glossary of Business Valuation Terms*³ defines the necessary terms of art:

Tangible assets – physical assets (such as cash, accounts receivable, inventory, property, plant and equipment, etc.).

Intangible assets – non-physical assets such as franchises, trademarks, patents, copyrights, goodwill, equities, mineral rights, securities and contracts (as distinguished from physical assets) that grant rights and privileges, and have value for the owner.

Goodwill – that intangible asset arising as a result of name, reputation, customer loyalty, location, products, and similar factors not separately identified.

Going concern value – the value of a business enterprises that is expected to continue to operate into the future. The intangible elements of Going Concern Value result from factors such as having a trained work force, an operational plant, and the necessary licenses, systems and procedures in place.

*Valuing Small Businesses and Professional Practices*⁴ further defines personal (professional) goodwill and business (practice) goodwill as follows:

Professional goodwill is the intangible value in the nature of goodwill that is associated primarily with the individual practitioner.

Practice goodwill is the intangible value in the nature of goodwill that is associated primarily with the practice as an institutional entity.

Sampling of Cases Excluding Personal Goodwill in Operating Companies

While the issue of personal goodwill has most often arisen when valuing professional practices, personal goodwill in operating businesses has been found to exist in multiple jurisdictions in equitable distribution cases. For example:

- *Lankford*⁵. Wife appealed the trial court’s valuation of a logging business that excluded the personal goodwill of the husband. “Unlike in the cases relied on by wife, the facts here show that the success or failure of the business depends on husband’s personal services and his ability to negotiate contracts in a fluctuating and depressed market. On *de novo* review, we agree with the trial court’s valuation of the business.”

- *Foley*⁶. Petitioner wife appealed the trial court's finding that the value of the family business known as [EMD], which manufactures electronic wire harnesses for the automotive industry, did not include a value for the goodwill of the enterprise. "[The husband's expert] did consider the factor of goodwill [He] testified that the goodwill of EMD rested with [the husband], with whom all of the customers did their business, rather than in the products or the service produced by EMD. [The expert] distinguished enterprise goodwill, which he found lacking in EMD, from personal goodwill, which he found to exist in [the husband] as the owner of EMD. We do not believe that [the expert's] evaluation of the goodwill of EMD was erroneous"
- *Troutman*⁷. The court held that goodwill should not be included for valuation purposes. "... Mr. Troutman's metamorphosis from an electrician working for another person to sole proprietorship speaks well of his skill. The success rests in large part upon the key man and Mr. Troutman was the key man. This ... recognizes the reality as to who ... generated the business. The court is satisfied that goodwill should not be factored in because the company was essentially Ron Troutman."
- *Young*⁸. Wife's expert conceded a large part of the value related to the husband's association with a small newspaper business. "Because the business earned revenue solely through advertising, the personal relationships husband developed with his advertisers was particularly significant in any valuation." The court found the business to have a fair market value of \$ 19,000, citing that "the [husband's] role and involvement in this enterprise are an essential element of its value."
- *Frazier*⁹. During the marriage, both parties owned a retail furniture company. Because the trial court did not exclude the spouses' personal goodwill, the court remanded the case for the trial court to revalue the company excluding personal goodwill.
- *Hough*¹⁰. Husband was heavily involved in the day-to-day management and operation of a vending business. The most disputed trial issue concerned whether, and to what degree, its continued success depended on personal goodwill attributable to him. "On appeal, Mrs. Hough's best-scenario argument would have us reject the facts on which Mr. Hough's expert based his assumptions about the existence of personal goodwill attributable to Mr. Hough. We are unable to do so because our careful review of the extensive record discloses evidence, albeit contested, to support those assumptions."
- *Moretti*¹¹. The trial court held that the value of the husband's landscaping business included goodwill. The supreme court remanded the case for the trial court to distinguish between enterprise and personal goodwill.
- *Champion*¹². The husband operated his own telecommunications business. The husband's expert made a distinction between enterprise goodwill and personal goodwill; he concluded that the goodwill was personal to the husband/owner and, therefore, not transferable. The trial court accepted the expert's opinion that any goodwill generated by the business was personal to the husband, and as such, would not be transferable to any potential successors in ownership. The appellate court upheld the trial judge's finding because it was not clearly erroneous.

Interestingly, the issue of personal versus business goodwill in operating companies has arisen outside of the equitable distribution/marital dissolution arena, as is evidenced by two recent Tax Court cases. It is worthy to note that the standard of value in the United States Tax Court is fair market value, the same standard applied in many divorce valuations.

- It can be expensive to liquidate (sell) a corporation due to the overall tax liability that must be paid on the sale of assets. In *Martin Ice Cream Company*¹³ and *Cascade Designs, Inc.*¹⁴, the respective shareholders were deemed to personally own certain intangibles. When the companies were sold/liquidated, the separately owned intangibles were not taxed at the corporate level – they were taxed outside the corporate entity at individual capital gain rates.

These tax cases give shareholders in closely-held operating companies the ability to generate personal goodwill which they own, value, and can dispose of separately from the corporations. The Tax Court cited that such personal goodwill exists in this context when there are no non-compete or employment agreements between the corporation and the owner (otherwise, the personal goodwill would be deemed “sold” to the corporation for the adequate consideration paid/payable by such agreements).

Three Basic Valuation Questions

In order to value an enterprise without personal goodwill, we must delve further into how businesses are valued. For example, depending on the purpose of the valuation one standard of value may be more appropriate than another. The standard of value answers the basic question: “Value to whom?”. The answer to this question can be framed in three different contexts.

1. *Fair market value* - The price a hypothetical willing buyer would pay to a hypothetical willing seller with neither party under compulsion to transact and both parties having reasonable knowledge of the relevant facts. This standard of value is universally used in all income-, gift-, and estate-tax purpose valuations.
2. *Fair value* - The price that fairly compensates an owner who was involuntarily deprived of the benefit of his/her ownership interest where there is neither a willing buyer nor a willing seller. This is a state specific, statutory standard used primarily in cases involving dissenting stockholder and other types of shareholder litigation.
3. *Investment value* - The price that an identified buyer (or class of buyers) would be expected to pay with consideration given to any unique benefits or synergies that the buyer is purchasing. This value is most appropriate in business purchase/sale transactions where the buyers and sellers are likely to know each other and, in fact, may be cooperating through the due diligence process.

Clearly, in a marital dissolution proceeding the appraiser’s goal is to value the ownership interest of the in-spouse. However, in many states the standard of value is fair market value. Thus, the in-spouse’s interest is represented by a hypothetical willing seller, it is assumed to be purchased by a hypothetical willing buyer, and in a transaction that, more than likely, will never occur. (A notable exception to the fair market value standard recently occurred in *Brown*¹⁵, where the appellate court applied a fair value standard.)

Another basic valuation question is the notion of “**Valued how?**”. This is primarily a function of the approach used to value the entity. Generally, the value of a privately held company is determined with a view towards the value of (a) the underlying net assets, (b) some future economic income flow, and/or (c) similar ownership interests transferred in private and public company transactions. These views have evolved to form the basis for three broad approaches used in valuing a closely-held company:

1. Asset-Based Approach
2. Income-Based Approach
3. Market-Based Approach

Within these approaches are different methods for determining a business value. The applicability of each approach and the subset of methods contained thereunder are assessed, given the nature and purpose of a particular valuation assignment. While a detailed explanation of these approaches and methods is beyond the scope of this article, they are all appropriately considered by appraisers in a valuation for divorce purposes.

A final question, “**Under what circumstances?**”, concerns (a) the assumption about what is going to happen to the business and (b) the “level” of value of the in-spouse’s business interest that is the subject of the report.

1. *Going concern value* – Assumes that the business was operating yesterday, is operating today, and will be operating tomorrow, and the value of that business is best determined by the earnings or cash flow it generates for the benefit of its investors.
2. *Liquidation value* – Assumes that the business is worth more broken up, its assets sold in an orderly or forced manner. If the holder of the appraised interest can force such an action to occur, the liquidation value of assets less liabilities could be an appropriate measure of value. Depending on the existence of goodwill this may, in fact, be the case.
3. *Control value* – Is the additional value inherent in a greater than 50% interest, reflecting the power of a shareholder over the business. Different levels of control value are possible depending on the rights and/or restrictions that are associated with a particular sized block of stock under state law, e.g., simple vs. supervoting majority.
4. *Lack of control value* – Refers to the value of two 50/50 interests or the value of any non-voting interests, e.g., non-voting stock or a limited partnership interest.
5. *Minority value* – The value reflecting an ownership position of less than 50% and the associated inability to make decisions that affect corporate policy. Different levels of minority value are possible, e.g., a minority interest that is the largest equity interest due to fractionalization of ownership or a minority interest with swing vote attributes.
6. *Non-marketable value* – Incorporates a discount for lack of marketability owing to the lack of a ready market of buyers and sellers for closely-held stock.

While most businesses are valued as a going concern, there are exceptions. The level of value (numbers 3 through 6) is easily seen as a function of the size of the in-spouse’s percentage ownership in the business.

Factors To Identify/Separate Personal Goodwill From Business Goodwill

Before the appraisal process can begin, it would be helpful to know if personal goodwill exists in the business being valued. The following table lists various factors that should be considered to identify and, perhaps, separate personal and business goodwill. This list of factors was compiled from various valuation textbooks, court cases (e.g., *Lopez*¹⁶), and personal experience in performing divorce valuations.

Factors To Consider	P	B
1) Type of Service		
Labor intensive vs. machine intensive manufacturing process		
Personal vs. automated ordering service		
Closeness of customer contact with owner or business		
Association of quality and cost with owner or business		
Reputation for honesty and fair dealing with owner or business		
2) Customers		
Customers referred to owner or business		
Customers referred by customers or other means		
Customers speak well of owner or business		
Number of customers		
Amount of retained/repeat business		
3) The Company		
Start-up or mature business		
Trade name, d/b/a, or named after owner		
Number of owners		
Development of middle management team		
Trained and assembled workforce		
In-place systems, operating procedures, etc.		
4) The Owner		
Personal reputation		
Community visibility		
Age and health		
Work habits and hours worked		
Knowledge, judgment, ability, and skills required for the business		
5) Other		
Size of buyer market and power over the owner or business		
Financing secured by personal guarantees of owner or business assets		
Earlier sale of ownership interest precedent with or without covenant		
Ownership interest can be sold without restrictive covenants		
Business can generate revenue from continued patronage without owner		
Totals		

P = Personal Goodwill (not transferable/not valued)

B = Business Goodwill (transferable/valued)

The *modus operandi* for using this table is as follows:

1. Determine if the element of goodwill exists, and if so, decide if it is associated with the in-spouse owner or with the business. If the element of goodwill does not exist, indicate as "not applicable".
2. For each element of goodwill that does exist, put an "x" in the appropriate column. Then, numerically total the x's in each column.
3. A preponderance of factors in either column may indicate that any attempt to separate personal and business goodwill is a moot point. That is, it is either all personal goodwill or all business goodwill.

Other Helpful Questions

In addition to analyzing the above factors, it may be helpful to ask the following questions in a divorce valuation:

1. What is a buyer buying when he/she purchases the in-spouse's interest?
2. What is a seller selling when he/she sells the in-spouse's interest?
3. If the in-spouse's interest is a 100% ownership interest, are not the in-spouse's interest and the business one and the same?

After analyzing the factors and answering the questions it should become apparent what is being bought/sold and whether 100% of the goodwill can accompany the transfer. This sentiment is echoed by Pratt: "The elements that create goodwill in a buy-sell situation are somewhat different from those considered in a valuation for marital dissolution purposes."¹⁷ For example, a buyer may purchase the business only with a noncompete agreement from the in-spouse. In his article, Mr. Barrett points out: "Various states have formed differing opinions as to whether a noncompete agreement should be considered a marital asset. Several take the position that the noncompete agreement is not a marital asset because it restricts the postmarital activity of the owner spouse."¹⁸ I would take the position it is not a marital asset because the embodiment of the noncompete agreement is, in fact, personal goodwill. Otherwise, the buyer would not need the protection of the agreement to ensure what is essentially a transfer of personal goodwill. Note that the foregoing assumes that the agreement has economic merit and is not simply a tax-planning device to allocate purchase price.

Approaches for Valuing an Operating Business When Personal Goodwill is Present and Must Be Excluded

Divorce valuations follow the standard operating procedures of "normal" valuations unless personal goodwill exists, and the jurisdiction excludes such goodwill for equitable distribution. If that is the case, approaches must be developed that will allow an appraiser to carve out personal goodwill and value only what is properly included in the marital estate. Conceptually, this will value the business's tangible assets, its business goodwill, and any other identifiable intangible assets (e.g., going concern value) that are not part of personal goodwill. The work to be accomplished can be represented as follows:

Total value of business
Less: Value of personal goodwill

Equals: Value of business for equitable distribution
Times: In-spouse's ownership percentage
Equals: Value of ownership interest for equitable distribution

Depending on the nature of the business, the extent of available information, and, quite frankly, the budget available to perform the engagement, three approaches come to mind as to how this may be accomplished.

Top-Down Approach. This approach gets its name because the business is valued at its highest (top) value and then whittled away to arrive at the value for equitable distribution. An appraiser would value the business as it would be done under any other circumstances. The most likely methods used to value an operating business would be discounted cash flow, capitalization of cash flow, completed transactions, and/or guideline companies. Since these methods would collectively value all of the enterprise's intangible assets, the appraiser would then identify all of the discrete components of personal goodwill (using the chart above as a starting point), value them, and subtract them from total business value. One example of a personal goodwill intangible might be the name of the in-spouse owner if it is firmly established as the name of the business. Another example is the value of the in-spouse owner's customer relationships (which may or may not be the same as the customer list).

Bottom-Up Approach. This approach gets its name because the business value would start at a floor (bottom) and then be built up with the value of the identifiable intangibles belonging to the business and the value of business goodwill. The floor value would be calculated using adjusted book value, which adjusts the reported book values of a company's assets and liabilities to their fair market value. In this context, assets are defined to be tangible assets (such as accounts receivable, inventory, and fixed assets) and identifiable intangible assets (such as patents, copyrights, and trademarks). To this would be added components of business goodwill, such as business location, workforce in-place, proprietary software, blueprints and drawings an internet web site, etc.

With & Without Approach. This approach requires two separate valuations. First, the business would be valued with the in-spouse owner as of the valuation date (an "as is, where is" valuation). Next, the business would be valued without the in-spouse owner as of the same date. Presumably the value of the former would exceed the value of the latter (because without the personal goodwill of the in-spouse, the business would have less revenue and/or higher expenses), and the difference would be the value of the personal goodwill.

Summary

Separating personal and business goodwill is fast-becoming a requirement in business valuations for martial dissolution purposes. The reason is that courts in multiple jurisdictions have held that personal goodwill is not a marital asset subject to equitable distribution. Valuing a business without personal goodwill is easy in theory but difficult in practice. Fortunately, evolving multi-factor tests and existing business valuation methodologies give appraisers the tools they need to tackle this challenge.

Endnotes

1. Barrett, Jr., John E, "Bifurcating Enterprise and Personal Goodwill", *American Journal of Family Law*, Summer 2002, Vol. 16, No. 2, pp. 129-132.
2. Pratt, Shannon P., Robert F. Reilly, and Robert P. Schweih, *Valuing Small Businesses and Professional Practices*, 3rd ed., p. 744.
3. *The International Glossary of Business Valuation Terms*, adopted by the American Institute of Certified Public Accountants, the American Society of Appraisers, the Canadian Institute of Chartered Business Valuators, the National Association of Certified Valuation Analysts, and the Institute of Business Appraisers.
4. Pratt, p. 584. It is interesting to note that the listed terms are defined only in the context of a professional practice and not for an operating entity. Perhaps the date of Pratt's treatise (1998) is the reason, as case law involving personal goodwill of operating companies was not as prevalent then as it is today.
5. *Marriage of Lankford*, 79 Ore. App. 742; 720 P.2d 407; 1986 Ore. App. LEXIS 2909 (June 4, 1986).
6. *Marriage of Foley*, 163 Ill. App. 3d 1; 516 N.E.2d 455; 1987 Ill. App. LEXIS 3474 (October 21, 1987).
7. *Troutman v. Troutman*, 1991 Del. Fam. Ct. LEXIS 39 (January 22, 1991).
8. *Young v. Young*, 1999 Ohio App. LEXIS 1744 (Ohio Ct. App., April 19, 1999).
9. *Frazier v. Frazier*, 737, N.E. 2d 1220 (November 15, 2000).
10. *Hough v. Hough*, 793 So. 2d 57 (Fla. Dist. Ct. App., July 9, 2001).
11. *Moretti v. Moretti*, 766 A.2d 925 (R.I. 2001).
12. *Champion v. Champion*, 2002 Mass. App. LEXIS 363 (Mass. Ct. App., March 19, 2002).
13. *Martin Ice Cream Company* (110 TC 189, 1998).
14. *Cascade Designs, Inc.* (TCM 2000-58, 2000).
15. *Brown v. Brown*, 2002 N.J. Super. LEXIS 105 (N.J. Super. February 28, 2002).
16. *Marriage of Lopez*, 38 Cal.App.3d 93, 113 Cal.Rptr. 58 (1974).
17. Pratt, p. 586.
18. Barrett, p. 131.

TYPICAL OPERATING COMPANY CASE

ASA BV E Letter

Distributed by the Business Valuation Committee of the American Society of Appraisers
Editor, Terry J. Allen, CPA/ABV, ASA
Issue 7-43 November 12, 2003

CASE UPDATE:

Kerce v. Kerce, 2003 Tenn. App. LEXIS 608 (Tenn. Ct. App. August 29, 2003). Judge Cain.
Provided by *Shannon Pratt's Business Valuation Update* shannonp@bvresources.com.

DELAWARE BLOCK METHOD NOT APPROPRIATE IN MARITAL DISSOLUTION; VALUATION THAT CONSIDERED MULTIPLE FACTORS PREVAILS

KEY WORDS:

Marital dissolution, Expert testimony, Lay testimony, Income approach, Asset approach, Industry risk premium, Delaware block method, Revenue Ruling 59-60, Personal goodwill, German textbook importer

EXPERTS:

Don Carpenter, CPA (for wife)
Gregory Luna, CPA (for husband)

The primary issues in this marital dissolution were whether the trial court used a proper methodology in valuing the parties' business, International Book Import Service, Inc. (IBIS), and whether personal goodwill of wife was properly excluded from the value.

FACTS:

The parties formed IBIS early in marriage, with wife as the chief officer and business manager. Wife was the driving force behind the success of the company. One of wife's lay witnesses testified that the company was closely identified with wife in the eyes of the target market. Husband provided computer consulting services to the company, though he was also employed elsewhere as a full-time computer software program manager.

The company was operated out of a 10,500-square-foot commercial building owned by the parties and leased to the business. The sole business of the company was the import and sale of German textbooks.

VALUATION EVIDENCE:

Both parties presented the testimony of a business appraisal expert. Wife's expert, Don Carpenter, testified that the fair market value of IBIS was \$ 90,000. Carpenter used the income approach to value the company, and testified that the asset approach was not appropriate for this type of business. He considered numerous factors, including both parties' contributions to the company, the nature of the business, obsolete inventory, and "the particular risks attendant to the German textbook business." He also viewed the facilities the business was operated from.

Husband's expert, Gregory Luna, testified that the fair market value of IBIS was \$ 1,013,028. Luna used the Delaware block method, which he said "looks at market value of the company, the value of the assets, and the value of the earnings stream of the business based on history." Because there were no sales of IBIS stock, Luna gave the market value component zero weight. He based the asset value component on the balance sheet numbers, with GAAP adjustments. For his earning stream component, he "extended the earnings of the business over a period of five years, extended loss of obsolete inventory over eight years, and . . . estimated 15% pre-tax return on the business." Luna did not view the business facilities, did not consider the specific aspects of the German textbook business, and relied on information from husband about obsolete inventory and wife's importance to the business.

TRIAL COURT FINDINGS:

Based upon the evidence and testimony, the trial court valued IBIS at \$220,000. The trial court did not completely accept the valuation of Carpenter because it discounted husband's contribution to the business. It rejected Luna's valuation, on the other hand, because it included a significant amount that could only be classified as wife's personal goodwill. The court of appeals opinion includes a portion of the transcript in which the trial court questioned Luna about wife's importance to the business, during which Luna conceded that the business was only worth \$1,013,028 in wife's hands, and that it could not be sold for that amount.

HOLDING ON APPEAL AND RATIONALE:

On appeal, husband argued that the trial court should have disqualified the testimony of Carpenter because he did not use the Delaware block method or the method outlined in Revenue Ruling 59-60, based on prior Tennessee case law. The court of appeals rejected this argument, stating that:

"although Mr. Luna's methodology has been adopted by our Supreme Court for the purpose of assessing the fair value of a dissenter's shares in a closely held corporation, it is by no means the only acceptable method, and for the purposes of evaluating the entire business as a marital asset is not a snug fit under the circumstances."

The court of appeals also found that "Of overriding significance in the evaluation of IBIS is the degree to which the success of the business depends on [wife]." The court of appeals characterized this as wife's personal goodwill. Quoting from *Smith v. Smith*, 709 S.W.2d 588 (Tenn. Ct. App. 1985), the court said: "There is a disturbing inequity in compelling a professional practitioner to pay a spouse a share of intangible assets at judicially determined value that could not be realized by a sale or another method of liquidating value." In Tennessee, this personal goodwill is not a marital asset.

Because the trial court's valuation was within the range of evidence and was supported by the evidence in the record, including both expert and lay testimony, the court of appeals affirmed.

L. Kruschke, Editor